

Skating on Thin Ice – What deposit insurance scheme for Europe?

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A Commission proposal to introduce a further degree of harmonisation to deposit guarantee schemes (DGS) in the EU is raising fierce opposition in the member states, not least in France and Germany. The Commission proposes a minimum level of ex-ante funding, a maximum payout period of seven days, and mutual borrowing between schemes for cross-border failures, in which the newly created European Banking Authority will be involved.

Although all EU member states have deposit guarantee systems, they did not play a central role in the financial crisis, nor did they prevent bank runs. Apart from Northern Rock and the Icelandic banks, most banks were too big to fail and were bailed out by their own governments with taxpayers' money. Deposit protection systems were therefore not called upon, or the funds were used to bail out banks, not just to protect depositors. The question is: should the DGS be further harmonised, and if so, how and to what degree?

The objective of DGS is to protect depositors, to prevent bank runs, and to allow for the orderly resolution of banks, according to Rosa Lastra (Queen Mary University, London). But they may also increase moral hazard and financial fragility, if not accompanied by strict supervision and market discipline, in the view of Thorsten Beck (Tilburg University). Membership of schemes should be compulsory and coverage limited. DGS are best funded by the industry, as this internalises the cost of protection and reduces moral hazard incentives, which the industry tends to oppose.

Recent years have demonstrated that large, international banks live globally, but die nationally. Studies show that the higher the share of foreign deposits in financial institutions, the lower the incentive for domestic supervisors to intervene. It is therefore extremely important to align schemes at the international level, otherwise arbitrage and inefficiencies can be expected.

At EU level, deposit insurance is regulated by a 1994 Directive on deposit guarantee schemes, following the minimum harmonisation approach. The Directive made deposit protection obligatory and set a minimum level of coverage of € 20,000, leaving much room for national differences in the statute of the funds, in their funding, and the type of deposits/depositors insured. When the financial crisis hit, the failure of some DGS to honour and manage depositors' national and cross-border claims led to major government interventions. To

alleviate the pressures on banking systems, in October 2008 the EU decided to increase the minimum coverage to € 50,000 and later to €100,000, but left the remaining deficiencies to be addressed in a more elaborate proposal, which was published on 12 July 2010.

Mario Nava, Head of Unit in the European Commission, discussed the core aspects of the 2010 proposal, which has been presented as a 'recast' of the 1994 directive. The four main goals of the proposal are 1) faster payout, 2) better funding, 3) better spending and 4) mutual borrowing amongst different schemes. The Commission proposal does not go far enough for some, but too far for others. It does not harmonise the statute of funds (public or private) and the related governance issues; it does not address the problem of cross-border banks sufficiently, and does not tackle the use of funds for purposes other than depositor protection. For others, it goes too far in the direction of maximum harmonisation, through the minimum level of ex-ante funding, by extending the protection to all currencies, or through the mutual borrowing facility between DGS in the EU. The latter therefore consider this as a new proposal, not simply a recast of the 1994 directive.

Both MEPs present at the seminar, Peter Simon (EP rapporteur) and Sven Giegold called for more flexibility. Simon believed that the Commission is too eager to impose a single system, which he considers out of step with the subsidiarity principle. He called for some common requirements (level of coverage and pay-out), but objected to mutual borrowing. Giegold preferred a plurality of national systems. He stated a common standard should not mean total homogeneity – ownership structures could remain different. Giegold feared the proposal would be too much of a burden for small banks, whereas the real risks are with large players, which are protected by tax-payers' money. Depositor schemes should also be allowed to be used in case of early bank restructuring, on condition that the minimum coverage ratio of 1.5% ratio is immediately restored.

Dirk Cupei, Director of the Deposit Protection Fund of the Association of German Banks (BDB), and Alex Kuczynski, Director of Corporate Affairs of the British Financial Services Compensation Scheme, shed light on a number of challenges regarding the implementation of new deposit insurance regulation. Numerous aspects of the Commission proposal were welcomed, such as the ex-ante funding, harmonisation of information provision and harmonisation of the scope of consumer protection. There seems to be much less agreement, however, on the shortening of the pay-out delay to seven days, the calculation and distribution of the risk-adjusted contributions and the reach of the currency denomination of deposits.

Both academics indicated that DGS should be seen as part of a broader resolution framework (a 'seamless process' between supervision and crisis management), which is not clearly addressed in the Commission proposal. They both called for a special fund for pan-European banks, which should be part of a specific crisis management framework to address cross-national incentive imbalances and the particular supervisory problems that arise. In this context, Rosa Lastra suggested a 28th regime for large banks. Beck thought that a clear EU bank resolution framework was more important than complete convergence in the details of the financial safety net structures.